

General Information Letter: No opinion on whether taxpayer has nexus and income tax liability with Iowa.

January 12, 1999

Dear:

This is in response to your letter dated December 23, 1998. Illinois Department of Revenue ("Department") rules require that the Department issue two types of letter rulings, private letter rulings ("PLR") and general information letters ("GIL"). PLRs are issued by the Department in response to specific taxpayer inquiries concerning the application of a tax statute or rule to a particular fact situation. A PLR is binding on the Department, but only as to the taxpayer who is the subject of the request for ruling and only to the extent the facts recited in the PLR are correct and complete. GILs do not constitute statements of agency policy that apply, interpret or prescribe the tax law and are not binding on the Department. Although you have not specifically requested either type of ruling, the nature of your letter and the information provided require that we respond with a GIL. See 86 Ill. Adm. Code 1200.120(b) and (c), enclosed.

In your letter you have stated the following:

We have an S-Corporation with a physical business location only in Illinois. We sell franchises in Illinois and other states. We also sell supplies and receive royalties from the franchises. We pay income tax to Illinois on 100% of our profit.

We were recently contacted by the State of Iowa. Iowa told us that even though we don't have a physical location in Iowa, nor do we have employees or equipment in Iowa, we have a taxable nexus in Iowa because we are receiving royalties from our franchisee in Iowa. (See attached letter from Iowa)

Since we are an Illinois Corporation doing business in the State of Illinois, we would like to know if the State of Illinois agrees with the position that Iowa has taken.

RULING

The determination of nexus is extremely fact-dependent. As a result, the Department declines to issue private letter rulings on the issue of whether a particular taxpayer has nexus with a state. Nevertheless, please note the following general information regarding Illinois income tax applicable to the circumstances described by your letter.

Illinois has two distinct net income taxes, namely, the income tax imposed by section 201(a) of the Illinois Income Tax Act ("the IITA"; 35 ILCS 5/101 et seq.) and the Personal Property Tax Replacement Income Tax imposed by section 201(c). IITA section 205(c) exempts a Subchapter S corporation from the income tax imposed by IITA section 201(a), but not from the Personal Property Tax Replacement Income Tax. IITA section 202 defines the term "net income" to mean that portion of a taxpayer's base income allocable to Illinois under the provisions of Article 3 of the IITA. With regard to a Subchapter S corporation, base income refers to federal taxable income determined in accordance with section 1363(b) of the Internal Revenue Code ("IRC"), including those items

required by IRC section 1363(b)(1) to be separately stated. Allocation and apportionment of the base income of a Subchapter S corporation follows IITA section 308(c), which provides that such allocation and apportionment shall be made in the same manner as any other corporation.

The general rule of apportionment of business income under Article 3 is stated at IITA section 304(a) as follows:

If a [corporation] derives business income from this State and one or more other states, then, for tax years ending on or before December 30, 1998 ... such person's business income shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is the sum of the property factor (if any), the payroll factor (if any), and 200% of the sales factor (if any), and the denominator of which is 4 reduced by the number of factors other than the sales factor which have a denominator of zero and by an additional 2 if the sales factor has a denominator of zero.

This section describes a three-factor apportionment formula, designed to identify that portion of the income of an interstate business fairly attributable to Illinois. The formula thus averages the ratio of a corporation's property, payroll, and sales in Illinois to its total property, payroll, and sales everywhere. The resulting percentage is then multiplied by the corporation's total base income to arrive at the amount of income apportioned to Illinois.

The property factor is the fraction of the average value of a corporation's real and tangible personal property owned or rented and used in the business in Illinois over the average value of the total of such property owned or rented by the corporation (IITA §304(a)(1)). The payroll factor is the fraction of the amount paid in Illinois by a corporation as compensation over the total amount of compensation paid by the corporation (IITA §304(a)(2)). The sales factor (which is double-weighted under the formula) is the total sales of a corporation in Illinois over the total sales of the corporation everywhere (IITA §304(a)(3)).

In computing the sales factor, the term "sales" generally means all gross receipts derived by a corporation from transactions and activity in the regular course of its trade or business (86 Ill. Adm. Code 100.3370(a)(1)). In the case of sales of tangible personal property, such as supplies, sales are attributable to Illinois if the property is delivered or shipped to a purchaser in Illinois, regardless of the f.o.b. point (86 Ill. Adm. Code 100.3370(c)(1)). Regarding gross receipts from transactions other than sales of tangible personal property, such receipts are attributed to Illinois if the income producing activity that gave rise to the receipts is performed wholly within Illinois (86 Ill. Adm. Code 100.3370(c)(3)). Likewise, if the income producing activity is performed both inside and outside Illinois, but the greater part of the income producing activity is performed in Illinois based on costs of performance, then such gross receipts are attributed entirely to Illinois (*Id.*). The term "income producing activity" is defined to include the sale, licensing or other use of intangible personal property (*Id.*) The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted industry practice (*Id.*).

The transfer of a franchise will be treated as either a sale or license for purposes of Illinois income tax in accordance with its treatment under federal income tax law. Whether a transfer of a franchise constitutes a sale or license for federal income tax purposes is determined under IRC section 1253(a).

It has been stated in your letter that Iowa determined that the corporation engaged in licensing franchises to licensees in Iowa. In addition, that employees of the corporation have engaged in various activities in Iowa associated with the licenses, including inspecting products and services, training, and providing technical assistance. While the Department does not opine as to other states' laws, the same contacts of a foreign corporation occurring in Illinois would likely cause the corporation to be subject to Illinois income tax. In Illinois, a corporation is subject to income tax where any of its income is allocated or apportioned to Illinois under Article 3 of the IITA.

Thus, for example, if under Illinois income tax regulations section 100.3370(c)(3) business income derived by a corporation from the license of a franchise is attributable to Illinois, the corporation must calculate Illinois income tax by application of the three-factor formula (IITA section 304(a)). Likewise, where a taxpayer paid compensation in this state under Illinois income tax regulations section 100.3360, the taxpayer must calculate Illinois income tax pursuant to the three-factor formula.

Finally, you may wish to note that a corporation that properly calculates its Illinois net income using the apportionment formula because it has derived business income from Illinois and one or more other states does not pay tax in Illinois on 100% of its income.

Enclosed please find a copy of the IITA sections and Illinois regulations referred to herein.

As stated above, this is a GIL which does not constitute a statement of policy that applies, interprets or prescribes the tax laws, and it is not binding on the Department.

Sincerely,

Brian L. Stocker
Staff Attorney (Income Tax)